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# **What Broke the Bubble?**

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**Abstract:** This paper is the basis for the Guest Columnist article in the Tuesday, November 11, 2008 issue of the *Kansas City Star Business Weekly*. Because of space limitations, the published newspaper column had to be shortened from the original and unfortunately did not include either of the two supporting figures. This is the unedited source article.

The position taken by this opinion editorial is that the declining trend of total reserves during the recent period of financial crisis was counterproductive, and the declining level of the federal funds rate during that period was an inadequate indicator of Federal Reserve policy stance. But the recent startling surge in reserves potentially offsets the problem, although for reasons not motivated by the issues raised by this article. In fact, the reason for the surge is associated with the declining stock of Treasury bonds available to the Federal Reserve for sterilization of the effects of the new lending initiatives on bank reserves.

**Keywords:** bubbles, bailouts, monetary policy, reserves, TAFs, sterilization, financial crisis.

**JEL Codes:** E32, E44, E52, E61, G18, G28.

## *1. Background*

It is widely believed that the recent bubble economy was accommodated by years of excessively expansionary monetary policy. Since all bubbles eventually burst, it is thereby argued that the current problems were unavoidable. Whether or not that view is correct, it is interesting to ask what broke the bubble, even if it eventually would have burst anyway.

Inspection of Federal Reserve data provides relevant information and most recently provides some encouraging news.

By conventional measures, the Fed has been easing its monetary policy stance by reducing its target value for the federal funds interest rate from 4.25 percent at the beginning of the year to its current level of 1.0 percent. Has the Fed thereby been engaging in actions that are stimulative to economic activity? Low interest rates do not an expansionary monetary policy make.

It is helpful to illustrate the problem with a different central bank activity: sterilized exchange rate intervention. When the Fed decides to intervene in foreign exchange markets, its foreign desk swaps dollar-denominated assets for assets denominated in a foreign currency. Left unchecked at this point, the reserves of the U.S. banking system (and the U.S. money supply) would change, as would the market value of the federal funds interest rate. To sterilize the foreign exchange transaction, the domestic desk of the Fed, in a subsequent operation, either buys or sells U.S. Treasuries in a magnitude sufficient to offset the impact of the foreign desk's activity and thereby keeps the U.S. money supply, the federal funds rate, and the reserves of the U.S. banking system unchanged. On net, two things are accomplished by these offsetting transactions by the Fed's foreign and domestic desks: creating the symbolic gesture of "doing something" about the dollar's value and exposing the U.S. taxpayer to potential losses, if subsequent changes in the exchange rate cause losses in the market value of the foreign assets now on the Fed's books.

## *2. Recent Experience*

Similarly, much Federal Reserve activity this year, including its role in bailouts, has been sterilized and has had little effect on bank reserves, while exposing the taxpayers to sub-standard asset risk. To illustrate the point, the Federal Reserve Figure 1 chart below shows the total

amount of reserves in the U.S banking system over the past five years. Note that reserves – the raw material from which loans and spending are created – are lower in mid-2008 than in August of 2003! But changes in the funds rate are usually interpreted in the media as the product of Fed policy actions. According to that view, if the funds rate declines, it must be the result of an expansionary monetary policy action. Missing from this analysis is the other side of the reserves market: those who demand reserves have some ability to affect the price – i.e., the federal funds rate – at which reserves trade. Those demanders are banks that see the demand for reserves rise and fall along with the demand for loans. When the demand for loans falls, the demand for reserves by banks declines. Hence, the federal funds rate can decline, because of declines in the demands for loans and reserves, without the Fed taking any policy action. While a decline in the funds rate is usually interpreted as “evidence” of an easy policy stance, the real signal in the market may be that the economy is weakening. As David Laidler, at the University of Western Ontario, has pointed out, this appears to be what happened in Japan during the 1990s. The Bank of Japan thought its monetary policy was “easy” because interest rates were low. The Japanese economy did not begin its recovery, after a decade of stagnation, until the quantity of money began to expand.

The Great Depression and the recent history of Japan’s long stagnation reveal that low interest rates, *per se*, are ambiguous indicators of the relative ease of monetary policy. The missing ingredient is the flow of bank reserves, the ultimate source of credit from which all other lending ultimately grows. For better or for worse, intentional or unintentional, herein may lie the pin that pricked the recent bubble.

### *3. Implications for the Future*

But there now is good news. Subsequent to the Fed's publication of the discouraging Figure 1 chart below, there has just been an enormous surge of reserves injected into the banking system through the Fed's lender-of-last-resort function at its discount window; through the new credit facilities, such as the Primary Dealer Credit Facility and Term Auction Facility; and through the long overdue initiation of the Fed's payment of interest on reserves – an important new reform that provides an incentive for banks to increase their holdings of reserves. See Federal Reserve chart, Figure 2. Although uncertainty in financial markets remains high, the recent dramatic injection of reserves by the Fed is encouraging, despite the fact that it was motivated by a shortage in Treasury bonds available to the Federal Reserve for sterilization. There is light at the end of the tunnel.

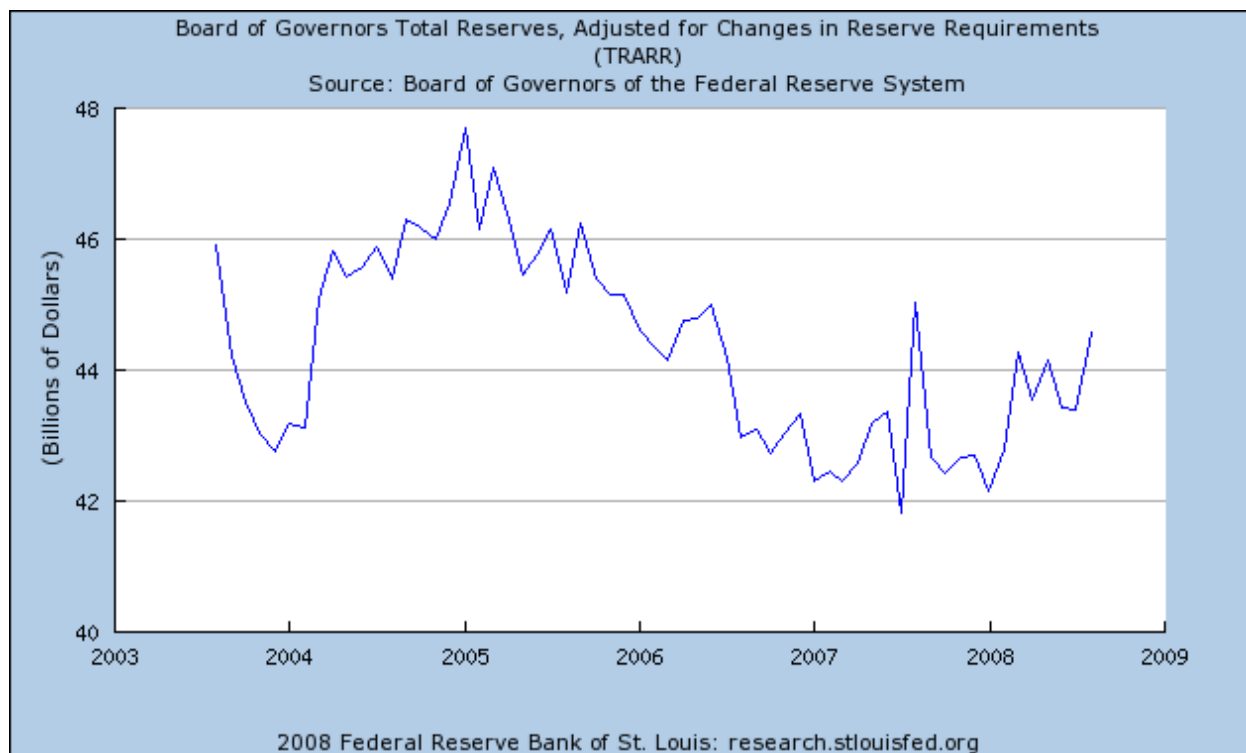


Figure 1: Total Reserves until Very Recently

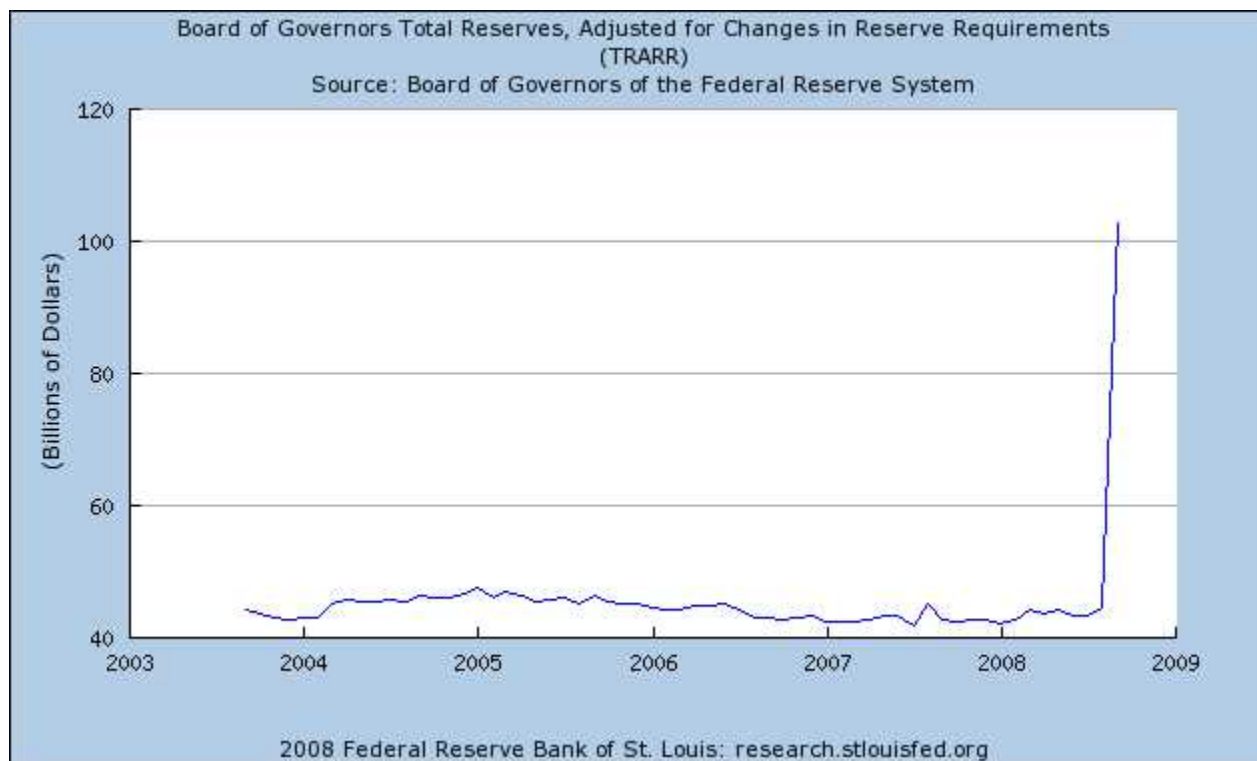


Figure 2: Total Reserves Including Recent Surge

## References

Barnett, William A. (2008), “Why Did Bubble Pop?”, *Kansas City Star*, Business Weekly, Tuesday, November 11, Section D, pp. D8 – D9.

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